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Before the
Federal Communications Commission
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of	)	
	)	
Bell Operating Company Provision of	)	CC Docket No. 96-21
Out-of- Region Interstate, Interexchange	)	
Services	)	

DOCKET FILE COPY ORIGINAL

To: The Commission

BELLSOUTH REPLY COMMENTS

John F. Beasley
William B. Barfield
Jim O. Llewellyn
1155 Peachtree Street, NE, Suite 1800
Atlanta, GA 30309-2641
(404) 249-4445

Charles P. Featherstun
David G. Richards
1133 21st Street, NW
Washington, DC 20036
(202) 463-4132

Its Attorneys

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SUMMARY

There is no basis for regulating BOCs providing out-of-region interexchange service as dominant or for subjecting them to structural separation requirements. Under the Commission's test for determining dominance, BOCs are non-dominant in the overall interexchange market. Nevertheless, a number of commenters, including AT&T, argue that BOCs should be regulated as dominant, even for out-of-region services, in the interexchange market because they control in-region local exchange facilities. These parties rely on an outdated test, however, for determining dominance rather than the current test for determining dominance: whether a firm "has the ability to control price with respect to the overall relevant market." Under this test, there is no reason to conclude that BOCs have market power in the interexchange market outside their local exchange service areas. Accordingly, there is no basis for regulating BOCs as dominant carriers for out-of-region interexchange services.

There also is no basis for imposing separation requirements or other safeguards on the BOC provision of interexchange services. It makes no sense to require new entrants with no market share to satisfy separation requirements before they qualify for non-dominant treatment, when the principal facilities-based incumbents in the market are regulated as non-dominant without having to satisfy any separation requirements. There are adequate non-structural safeguards in place. BOCs are regulated as dominant carriers in the provision of local exchange service and their interstate access rates are subject to price cap regulations and must be provided pursuant to tariffs under Title II. Moreover, if BOC out-of-region interexchange services are treated as nonregulated services, they will be subject to accounting, cost allocation, affiliate transaction, and other non-structural safeguards under the Commission's rules.

Dominant carrier regulation adversely affects the BOCs' ability to compete with incumbent interexchange providers. In addition to compliance costs, dominant carrier regulation creates market inefficiencies and "inhibits [carriers] from quickly introducing new services and from quickly responding to new offerings by . . . rivals." In addition, dominant carrier tariffs take longer to become effective than non-dominant carrier tariffs. Thus, regulating the BOCs as dominant would give the incumbent interexchange providers, all of which have been declared non-dominant, the ability to "use the regulatory process to delay and . . . thwart" new competition from BOCs.

The Commission's proposal to regulate BOCs as dominant in the provision of out-of-region interexchange services, unless structurally separated, also is inconsistent with the Telecommunications Act of 1996. The 1996 Act created "a procompetitive, deregulatory national telecommunications policy framework" and requires the Commission to forbear from applying needless or duplicative regulations.

Finally, BellSouth disagrees with the position of some commenters that the 1996 Act does not permit BOCs to offer long distance service to CMRS customers as an "incidental" service pursuant to Section 271. Under Section 271(g)(3), permissible incidental interLATA services specifically include CMRS. Thus, all services falling within the definition of CMRS that are interLATA in nature may be offered as incidental services, including bundled interexchange service offered to CMRS customers. As an end-to-end offering, the bundled service should be regulated as interLATA CMRS, and *not* as the out-of-region provision of interLATA service.

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To: The Commission

BELLSOUTH REPLY COMMENTS

BellSouth Corporation ("BellSouth"), by its attorneys, hereby replies to comments submitted in response to the Commission's *Notice of Proposed Rule Making*, CC Docket No. 96-21, FCC 96-59 (Feb. 14, 1996), 61 Fed. Reg. 6607 (1996) ("*NPRM*").

In its comments, BellSouth established that:

- To be classified as dominant, a carrier must have the ability to control price (*i.e.*, market power) in the particular market under consideration;[1]
- The market under consideration in this proceeding is the interstate, domestic, interexchange service market, with no relevant submarkets;[2]
- BOCs do not have the ability to control price in the interstate, domestic inter-exchange service market;[3] and

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1 BellSouth Comments at 6 (citing *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor*, CC Docket No. 79-252, *First Report and Order*, 85 F.C.C.2d 1, 10, 21 (1980) ("*First Report*").

2 BellSouth Comments at 5. *Accord* AT&T Comments at 4.

3 BellSouth Comments at 9-11.

- Dominance in one market does not create dominance in another market.[4]

The Commission itself observes that "upon entry into the provision of out-of-region interstate, interexchange services, BOC affiliates would not be likely to possess market power."[5] Accordingly, BellSouth concluded that there was no basis for regulating BOCs as dominant in the provision of interstate, domestic, interexchange services.

Nevertheless, incumbents in the interstate, domestic, interexchange service market urge the Commission to impose even more burdensome separation and reporting requirements than those proposed in the *NPRM,* on BOCs wishing to enter the interexchange market outside their regions.[6] Some commenters even urge the Commission to impose dominant-carrier regulation on BOC out-of-region services even when offered through structurally separated subsidiaries.[7] As discussed in BellSouth's comments, however, there is no basis for imposing any such requirements on BOCs in the provision of interexchange service because under the Commission's test for determining dominance, BOCs are non-dominant in the overall interexchange market.[8]

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4 BellSouth Comments at 7-9.

5 *NPRM* at ¶ 8.

6 AT&T Comments at 3, 7-8; MCI Comments at 10-24; Sprint Comments at 3-4; Cable & Wireless, Inc. Comments at 2-5; Excel Telecommunications, Inc. Comments at 2-7.

7 MCI Comments at 10-17; Telecommunications Resellers Association Comments at 2.

8 In CC Docket 96-61, the Commission recently invited comments on whether to change the relevant geographic and product markets for interexchange services. *See* "Commission Proposes that Long Distance Companies be Relieved of Tariff Filing Requirements," FCC NEWS, Report No. DC-96-24 (Mar. 21, 1996) (*Interexchange Detariffing Notice*).

I. DOMINANCE IN THE LOCAL EXCHANGE MARKET DOES NOT CREATE DOMINANCE IN THE INTERSTATE, DOMESTIC, INTER-EXCHANGE SERVICES MARKET

A number of commenters, including AT&T, argue that BOCs should be regulated as dominant in the interexchange market because they control bottleneck facilities in the local exchange market.[9] AT&T relies on an outdated FCC statement that control of local exchange facilities was "prima facie evidence of market power" in the nationwide interexchange market as a primary basis for its belief that BOCs should be regulated as dominant carriers in the provision of out-of-region interexchange service.[10] Contrary to AT&T's claim, however, this statement is no longer valid.[11]

As explained in BellSouth's initial comments, control of local exchange facilities formerly was prima facie evidence of market power in *all* markets, including the interexchange market.[12] Under this early approach to dominance, a carrier was deemed dominant if it held market power in *any* market.[13] This "all-services" approach to dominance was expressly rejected by the Commission, however, in the *AT&T Non-Dominance Proceeding* where the Commission held that the central issue is whether a firm "has the ability to control price with respect to the overall relevant market."[14] In fact, the FCC had to depart from its "all-services" approach in order to declare AT&T non-

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9 AT&T Comments at 6; MCI Comments at 5, 10-17; Excel Telecommunications, Inc. Comments at 2-4; Telecommunications Resellers Association Comments at 12-18; UTC Comments at 3; Competitive Telecommunications Association Comments ("CompTel") at 2-7.

10 AT&T Comments at 5-6.

11 AT&T Comments at 6.

12 BellSouth Comments at 5-7.

13 BellSouth Comments at 7 (citing *First Report*, 85 F.C.C.2d at 22 n.55).

14 *Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier*, 1 Com. Reg. (P&F) 63, 72, 74 (1995) ("*AT&T Non-Dominance Proceeding*"). *See* BellSouth Comments at 7-9.

dominant, because it found that AT&T remains dominant in the provision of international services and has the ability to control prices in portions of the domestic interexchange services market.[15]

If, in this proceeding, the Commission applies the test under which AT&T was declared non-dominant, BOCs must be declared non-dominant. Nevertheless, AT&T, after being found non-dominant, now seeks to protect itself from competition by proposing to scrap the test under which it was found non-dominant, in favor of returning to the "all-services" test that the FCC rejected in the *AT&T Non-Dominance Proceeding.*

AT&T claims that "there is no reason to conclude . . . that a BOC lacks market power in the out-of-region market."[16] In fact, the opposite is true: there is no reason to conclude that BOCs have market power in the interexchange market outside their local exchange service areas. They clearly do not have "the ability to control prices in the overall interstate, domestic, interexchange market."[17] In making a market power assessment, the Commission focuses on: (1) the company's market share in the relevant market; (2) the supply elasticity of the relevant market; (3) the demand elasticity for the company's customers; and (4) the company's cost structure, size, and resources. BellSouth showed conclusively in its comments that under these factors, BOCs do not have market power in the interexchange market.[18] In fact, commenters supporting regulation of BOCs as dominant in the

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15 *AT&T Non-Dominance Proceeding*, 1 Com. Reg. (P&F) at 92-93.; BellSouth Comments at 7-8.

16 AT&T Comments at 5.

17 *See AT&T Non-Dominance Proceeding*, 1 Com. Reg. (P&F) at 72.

18 *See* BellSouth Comments at 9-11. *Accord* Ameritech Comments at 2-5; SBC Communications, Inc. Comments at 8-9. Moreover, if the relevant geographic market for interexchange service is redefined, as the Commission recently proposed, the BOCs will even more clearly be found to lack the power to control prices in out-of-region geographic markets or submarkets because they lack LEC facilities. *See Interexchange Detariffing Notice* (announcing the adoption of a *Notice of Proposed Rulemaking* in CC Docket 96-61 to examine, among other things, whether to "change[] the relevant product and geographic market definitions for interstate, interexchange carriers.").

provision of interexchange service provide no economic data to support their self-serving assertions.

Some parties argue, however, that dominant carrier regulation is warranted with regard to the BOC provision of out-of-region interexchange service because BOCs may have a substantial out-of-region CMRS presence.[19] Clearly such a presence does not give a BOC market power in the interexchange market — indeed, it is completely irrelevant to a determination of market power in the interexchange market. Other companies with a substantial CMRS presence throughout the nation are not deemed dominant as a result of their CMRS presence. AT&T's national cellular operations, for example, were *not even considered* as a basis for classifying AT&T as a dominant interexchange carrier.[20]

In essence, the parties making this argument appear to be urging the Commission to impose regulation on the BOCs simply because of their size. AT&T, however, is both a larger CMRS provider than any BOC and the largest interexchange provider, yet it was recently found non-dominant in the interexchange market. Size alone simply is not a determining factor in the analysis.

MCI and others claim that a BOC will somehow provide preferential access arrangements for in-region termination of its interexchange traffic originated out-of-region.[21] This argument is fanciful. First, the BOCs will provide out-of-region interexchange service as resellers, at least initially, because they do not possess the national networks needed to function as facilities-based carriers. Thus, traffic originated by their out-of-region customers will be carried over another carrier's network to the BOC's access tandem and will use the access arrangements purchased by

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19 Vanguard Comments at 4-6; Association for Local Telecommunications Services Comments at 4.

20 *See AT&T Non-Dominance Proceeding*, 1 Com. Reg. (P&F) at 96-101.

21 Excel Telecommunications Comments at 4; Sprint Comments at 2; MCI Comments at 5-10.

the underlying carrier.[22] The BOC thus has no opportunity to establish preferential access arrangements for the termination of its own interexchange traffic.

Second, even if a BOC establishes its own wholly or partially facilities-based network, it will have no opportunity or incentive to discriminate in favor of its own interLATA traffic. Such traffic will be terminated on the same facilities as other interLATA carriers' traffic, subject to the same access charges. Any access arrangements a BOC made available for the termination of its own interLATA traffic would have to be made available to other carriers on a nondiscriminatory basis. Therefore, the BOC would have no economic incentive to favor its own terminating traffic, as that would cause it to forego important access revenues from other carriers.

There is no basis for regulating BOCs as dominant carriers or imposing separation requirements or other safeguards on the BOC provision of interexchange services, whether or not they offer CMRS service out-of-region. It makes no sense to require new entrants with no market share to satisfy separation requirements before they qualify for non-dominant treatment, when the principal facilities-based incumbents in the market are regulated as non-dominant without having to satisfy any separation requirements.

II. SAFEGUARDS ARE UNNECESSARY WITH REGARD TO THE BOCS' PROVISION OF OUT-OF-REGION, INTEREXCHANGE SERVICES

All parties supporting the imposition of dominant-carrier regulation on BOCs providing interstate services recite the same litany of concerns, which revolve around the BOCs' ability to leverage their power in the local exchange market in the interexchange market. There are sufficient regulations in place, however, to prevent such activity. For example, BOCs already are regulated as dominant carriers in the provision of local exchange service. Similarly, all BOC interstate access

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22 *See, e.g., Bell Atlantic Corp: Sprint's Wholesale Service Will Be Bought and Resold*, Wall St. J., Mar. 12, 1996, at B3; Catherine Arnst, *Operator, Please Connect Me*, BUSINESS WEEK, Feb. 26, 1996, at 33 (noting that Ameritech will resell WorldCom's long distance service).

rates are subject to price cap regulations and must be provided pursuant to tariffs under Title II.[23] Moreover, if BOC out-of-region interexchange services are treated as nonregulated services, they will be subject to accounting, cost allocation, affiliate transaction, and other non-structural safeguards under the Commission's rules.

BellSouth takes exception to MCI's proposal that BOCs should be required to provide all competitive services, including out-of-region interexchange services, through separate affiliates.[24] Its sole justification for this draconian recommendation is a reference to a handful of audits critical of LEC affiliate transactions and accounting practices.[25] *None* of the audits cited by MCI have been fully litigated: they were either resolved by consent decrees (with no admission of liability) or were not prosecuted. The audit reports cited by MCI in most cases were never made public: even the carriers audited were not given complete copies of the audit reports and supporting work papers. Therefore, these scattered incidents represent, at most, the unreviewed judgment of staff. They hardly form a sufficient factual basis for imposing costly structural separation requirements on the BOCs.

While BellSouth cannot respond to the issues raised with regard to other carriers, it can respond to the allegations of wrongdoing that MCI levels against BellSouth in particular. The first was an audit concluded in 1993 of affiliate transactions between BellSouth Services, Inc. and the BellSouth telephone companies.[26] The facts developed in the audit showed that BellSouth Services, Inc. operated as a cost center to provide support for the two BellSouth telephone companies. The

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[23] *See* BellSouth Comments at 12 (citing price cap orders).

[24] MCI Comments at 12.

[25] MCI Comments at 12-16.

[26] The audit dealt with the period prior to price cap regulation of the LECs, and has absolutely no probative value in analyzing the legal and policy issues presented in this docket.

record reflects that BellSouth Services targeted its services to earn the authorized rate of return and included a methodology that reflected any deviation from the authorized rate of return in one year as an adjustment to prices in the next year. Predictably, this methodology resulted in year to year swings in the earnings of BellSouth Services. The result of applying this methodology was that over the 1984-1990 time period audited, BellSouth Services earned $1.4 million *less* than the authorized rate of return of the regulated telephone companies. Under these circumstances, it is hardly surprising that the Commission elected not to prosecute BellSouth as a result of this audit. BellSouth's Statement, which was filed when the Commission released its Summary of Audit Findings, fully explains the facts surrounding this audit and BellSouth's response to the audit summary.[27]

The other audit involving BellSouth cited by MCI dealt with accounting for lobbying costs. Despite BellSouth's guidelines for the classification of lobbying costs which were carefully drawn to comply with both FCC and IRS regulations, the FCC's audit staff applied a definition of lobbying that was far more restrictive than either the text of the FCC rule or the jurisprudence interpreting the rule. BellSouth cooperated with the Commission staff and complies with its restrictive interpretation on a going-forward basis.

Nothing in BellSouth's conduct justifies the inflammatory statement leveled by MCI:

> In spite of these egregious violations, the Commission failed to take any remedial action for the past ratepayer injuries resulting from these mis-allocations. Its failure to take such remedial action confirms the inadequacy of the entire cost accounting regulation and audit function, since the LECs apparently have a "free shot" at any accounting violation they may wish to commit, knowing that the worst that can happen is that someday, if they are caught, they might have to correct such practices only on a going-forward basis.[28]

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27 The BellSouth Statement is attached as Appendix A to this filing.

28 MCI Comments at 14-15.

The Commission should not be swayed into making a poor policy choice by such irresponsible rhetoric. MCI takes these matters out of context and undermines the regulatory system by referencing consent decrees and decisions not to prosecute as evidence of BellSouth guilt and Commission neglect. If, however, a consent decree does not put to rest a contested matter and can be cited as an admission of wrongdoing, carriers will have an incentive to litigate rather than work cooperatively with the Commission to resolve contested issues. While this may serve the private interests of parties such as MCI, it certainly will not serve the public interest.[29]

Despite claims to the contrary, dominant carrier regulation adversely affects the BOCs' ability to compete with incumbent interexchange providers.[30] In addition to compliance costs, dominant carrier regulation creates market inefficiencies and "inhibits [carriers] from quickly introducing new services and from quickly responding to new offerings by . . . rivals."[31] In addition, dominant carrier tariffs take longer to become effective than non-dominant carrier tariffs.[32] Thus, incumbent interexchange providers (all of which have been declared non-dominant) can "use the

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29 MCI also cites the existence of the sharing mechanism in the LEC price cap plan as creating incentives to cross-subsidize (a term that MCI uses with reckless abandon) and shift costs. Ironically, although the obvious solution is to eliminate sharing from the LEC price cap plan, MCI steadfastly opposes the elimination of sharing. MCI's dogged pursuit of never ending, ever more onerous regulation of its potential competitors must be seen by the Commission for what it is: an anticompetitive abuse of the regulatory process for its own competitive advantage.

30 *See* Association for Local Telecommunications Services Comments at 1.

31 *See AT&T Non-Dominance Proceeding*, 1 Com. Reg. (P&F) at 73; *see also* BellSouth Comments at 3 n.11.

32 BellSouth notes that the Commission recently proposed to eliminate the tariff filing requirement for non-dominant carriers in a separate proceeding. This proposal only will exacerbate the competitive disadvantage BOCs will experience if subjected to dominant carrier regulation in the provision of out-of-region interexchange service. *See Interexchange Detariffing Notice.* BellSouth notes that in this newly instituted proceeding, the Commission appears to propose the elimination or modification of the very rules under consideration here. *Id.*, DC-96-24 at 2.

regulatory process to delay and . . . thwart" any competitive advantages sought by BOCs as new entrants by reducing prices.[33]

III. IMPOSING DOMINANT CARRIER REGULATION ON BOCS' PROVIDING OUT-OF-REGION INTEREXCHANGE SERVICES IS INCONSISTENT WITH THE DEREGULATORY NATURE OF THE TELECOMMUNICATIONS ACT OF 1996

The Commission should not adopt its proposal to regulate BOCs as dominant in the provision of out-of-region, interexchange services, unless structurally separated. Contrary to the position of some parties,[34] such a proposal is inconsistent with the Telecommunications Act of 1996 ("1996 Act"). As the Commission itself recognizes, the 1996 Act created "a procompetitive, deregulatory national telecommunications policy framework."[35] In this regard, Section 401 of the 1996 Act enacted a new Section 10 of the Communications Act which requires the Commission to forbear from applying regulations that are unnecessary to protect consumers or to ensure that rates and charges are non-discriminatory.

As stated above, BOCs already are subject to dominant carrier regulation in the provision of local exchange service. This regulation ensures that consumers are protected and the BOC LEC charges are just and reasonable. Adopting restrictive regulations for the BOC provision of interexchange service out-of-region, where the BOCs lack market power, would be inconsistent with the deregulatory nature of the 1996 Act, especially given that BOCs lack market power in the interexchange service market. If the Commission nevertheless adopts regulations imposing dominant carrier status on BOC out-of-region interexchange service offered without structural

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[33] *AT&T Non-Dominance Proceeding*, 1 Com. Reg. (P&F) at 73; SBC Communications, Inc. Comments at 2-4.

[34] *See* MCI Comments at 2; Sprint Comments at 5; Excel Telecommunications, Inc. Comments at 6.

[35] *See Interexchange Detariffing Notice*.

separation, BellSouth and other BOCs may find it necessary to petition for forbearance from such regulation under new Section 10(c) of the Act. Appropriate action in this proceeding will render it unnecessary for the Commission to address such petitions.

IV. BOCS SHOULD NOT BE REGULATED IN THE PROVISION OF INTER-EXCHANGE SERVICE TO THEIR CMRS SUBSCRIBERS

BellSouth strongly disagrees with the apparent position of some commenters that the 1996 Act does not permit BOCs to offer long distance service to CMRS customers as an "incidental" service pursuant to Section 271.[36] As an initial matter, this issue is outside the proper scope of this proceeding, which implements the provisions of the 1996 Act concerning "out-of-region" services, not "incidental" services.[37]

Under Section 271(g)(3), permissible incidental interLATA services specifically include CMRS. Thus, all services falling within the definition of CMRS that are interLATA in nature may be offered as incidental services. This includes the offering of bundled interexchange service to CMRS customers. CMRS is defined as a mobile service that is provided for profit and which makes interconnected service available to the public.[38] To the extent interexchange service is being offered by a CMRS provider in conjunction with mobile service, the interexchange service constitutes "interconnected service" and is thus part of the CMRS offered the customer. Section 271(b)(3) expressly allows BOCs to provide such incidental services "originating in *any* state" (*i.e.*, in or out of region).[39]

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36 *See, e.g.*, Vanguard Cellular Systems, Inc. Comments at 8 n.9.

37 *See NPRM* at ¶¶ 1, 6 (citing 47 U.S.C. § 271(b)(2)).

38 *See* 47 U.S.C. § 332(d)(1).

39 47 U.S.C. § 271(b)(3).

The bundling of the interexchange and CMRS service constitutes a unique, end-to-end service offering, and is not the out-of-region provision of interLATA service. Such an interpretation is consistent with the legislative history of the 1996 Act. As Senator Breaux stated:

> [T]he telecommunications legislation is a deregulatory bill, and I am particularly pleased in this regard with the provisions covering commercial mobile services that lift the restrictions now disadvantaging the BOC affiliated CMRS carriers.
>
> As soon as [the 1996 Act] is signed into law, the BOC affiliated commercial mobile service carriers can begin to offer *the full range of end-to-end interLATA services* to their mobile customers just as their competitors are able to do now. They need no government action or approval.[40]

Congress expressly determined that CMRS and other incidental interLATA services were *not* subject to a structural separation requirement.[41] Moreover, the Commission has determined that tariff regulation of CMRS is unnecessary, and it has recently proposed mandatory detariffing of interLATA services provided by non-dominant carriers, including AT&T.[42] There is no basis for subjecting BOC CMRS providers—including those providing toll service to their CMRS subscribers —to tariff regulation either as a dominant or non-dominant carrier, whether structurally separated or not. AT&T can offer toll service to its CMRS customers without tariffs (or separation requirements). There is thus no reason to treat BOC CMRS offerings differently.

CONCLUSION

For the foregoing reasons, as well as those referenced in its initial comments, BellSouth urges the Commission not to regulate BOCs as dominant in the provision of interexchange services, whether or not the service is offered directly or through a separated affiliate.

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40 Statement of Senator Breaux, 141 Cong. Rec. S 1311 (Feb. 26, 1996) (emphasis added).

41 *See* 47 U.S.C. § 272(a)(2)(B)(i).

42 *Implementation of Sections 3(n) and 332 of the Communications Act*, GN Docket No. 93-252, *Second Report and Order*, 9 F.C.C.R. 1411, 1480 (1994); *Interexchange Detariffing Notice*.

Respectfully submitted,

BELLSOUTH CORPORATION

By: ______________________
John F. Beasley
William B. Barfield
Jim O. Llewellyn
1155 Peachtree Street, NE, Suite 1800
Atlanta, GA 30309-2641
(404) 249-4445

By: ______________________
Charles P. Featherstun
David G. Richards
1133 21st Street, NW
Washington, DC 20036
(202) 463-4132

Its Attorneys

March 25, 1996

APPENDIX A

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
BellSouth Corporation	)	
BellSouth Telecommunications, Inc.	)	AAD 93-127
Request for Confidential Treatment of Certain Financial Information and Release of Audit Findings	)	

BELLSOUTH STATEMENT

On October 29, 1993, the Commission released a Memorandum Opinion and Order ("Order") in the captioned proceeding, FCC 93-487. The Order authorized the Common Carrier Bureau to release the staff's Summary of Audit Findings for public inspection on the sixth working day following service of the Order upon BellSouth Corporation and BellSouth Telecommunications, Inc. (collectively "BellSouth"), absent issuance of a judicial stay. BellSouth does not oppose the release of the Summary of Audit Findings, and no judicial stay will be sought.

BellSouth concurs with the Commission's conclusion that no further action with respect to the auditors' findings is necessary or appropriate. While BellSouth agrees with this result, BellSouth strongly disagrees with the findings and conclusions reached by the staff in the Summary of Audit Findings. As set forth below, BellSouth has at all times complied with the Commission's rules, and its conduct has resulted in no adverse impact on ratepayers.

The audit focused on the relationship between BellSouth Services, Inc. ("BSS") and BellSouth's regulated telephone companies, South Central Bell Telephone Company ("SCB") and Southern Bell Telephone and Telegraph Company ("SBT"). BSS was established in 1984 as a wholly owned subsidiary of SCB and SBT. Throughout its existence, BSS operated as a cost center, not a profit center, providing centralized staff services to its parent telephone companies. Initially (1984-1985) BSS priced the services it provided to SCB and SBT to simply recover its operating expenses with no return on capital included in its prices. Beginning in 1986, BSS included a return component in its prices that was designed to produce a return on capital equal to the authorized rate of return of its parents. Consistent with the guidance provided by the Commission in Docket No. 19129, BSS adopted procedures to monitor its earned rate of return and to adjust its prices prospectively to retarget its earnings to the authorized rate of return of SCB and SBT.

SCB and SBT also adopted procedures to insure that ratepayers received the benefit of the efficiencies produced by BSS. SCB and SBT included both their investment in, and dividends received from, BSS in the intrastate ratemaking process. Such treatment effectively flowed back any BSS earnings to intrastate ratepayers. BellSouth sought similar ratemaking treatment from this Commission in Docket No. 86-111, but its request was denied.

Although the Summary of Audit Findings does not directly allege any violation of FCC rules, it implies a violation of Section 32.27(d). That rule became effective on January 1, 1988. Yet the Summary of Audit Findings appears to have applied the standards adopted in that rule retroactively to the years 1984-1987. In addition, the staff apparently applied ratemaking principles governing capital leases that were adopted in 1988 to capital lease transactions between BSS and SCB/SBT that occurred in 1985-1987. BSS had properly reflected capital lease transactions on its books in accordance with Generally Accepted Accounting Principles. The staff's treatment of capital leases increased the alleged overearnings of BSS, particularly in 1986.

The staff Summary of Audit Findings is flawed in another respect. The staff calculated BSS' earned rate of return for each year, 1984-1990. The staff then disregarded years in which BSS earned less than the authorized rate of return (1988 and 1990). The staff also disregarded the impact of the voluntary rate reduction made by SCB and SBT in September, 1990. The staff methodology thus ignored the Commission's guidance in Docket 19129, where the Commission stated that earnings of affiliates on transactions with carriers would be evaluated on a five year, rolling average basis. The staff method also ignores the findings of the Court of Appeals in AT&T v. FCC, 836 F.2d 1386 (D.C. Cir.

1988), and Virgin Islands Telephone Company v. FCC, 989 F.2d 1231 (D.C. Cir. 1993), where the Court held that the Commission cannot look only at years (or parts of years) in which a carrier overearned and ignore those years in which a carrier underearned. The staff method also ignores the Commission's own Part 65 Rules, which not only provide for a two year monitoring period, but also for a "buffer" above the authorized rate of return to recognize the imprecision of the forecasting process. In short, the staff methodology evaluated BSS earnings much more restrictively than the Commission's prior guidance on affiliate transactions, and much more restrictively than the way the Commission reviews earnings of the regulated telephone companies.

While BellSouth strongly disagreed with many of the positions implicit in the staff's early audit methodology, BellSouth recognized at the outset that application of that methodology would lead to a conclusion that BSS had earned more than the telco authorized rate of return in some years. Despite the fact that BellSouth had not yet concluded its own investigation, in 1990 BSS, out of an abundance of caution, voluntarily credited to SCB/SBT $8.6 million, the amount that it estimated the application of the staff methodology would characterize as interstate "overearnings", with no offset for years in which BSS "underearned". In September, 1990, SCB/SBT reduced rates by $14.3 million in order to flow through to interstate access customers the interstate amount of the BSS credit, plus interest. SCB/SBT also voluntarily reduced their plant accounts by $3.9 million to reflect the rate base impact of the alleged "overearnings".

Despite these voluntary actions by BellSouth, both the Commission staff and BellSouth continued to investigate the transactions between BSS and SCB/SBT. Because it believed that many of the positions taken by the Commission staff during this audit were incorrect, BellSouth retained the firm of Deloitte & Touche to analyze the data submitted to the Commission staff and to evaluate BellSouth's compliance with the Commission's affiliate transaction rules and orders. Attached hereto is a summary compilation from Deloitte & Touche expressing their findings in this regard. Deloitte & Touche demonstrate that far from overcharging SCB/SBT, BSS earned over $10 million less than the authorized rate of return of SCB/SBT over the 1984-1990 time period. Even if the 1990 credit to SCB/SBT is not considered, BSS earned $1.4 million less than the SCB/SBT authorized rate of return. Thus, BSS did not overcharge SCB/SBT, and the telephone companies did not overcharge their ratepayers.

BellSouth appreciates the Commission's recognition of the voluntary steps that BellSouth took in 1990 to ensure that ratepayers were not disadvantaged by the relationship between BSS and SCB/SBT. As acknowledged in the Summary of

Audit Findings, even under the staff's methodology SCB/SBT voluntarily returned to interstate ratepayers $5.7 million more than the staff's calculation of overearnings plus interest. BellSouth remains committed to full and complete compliance with all Commission rules and orders.

In addition to the specific concerns with the staff's Summary of Audit Findings discussed above, BellSouth is concerned with the process followed in audits such as this one. BellSouth has not been provided with a copy of the full audit report prepared by the staff, and has been afforded no formal opportunity to object to possible factual or legal errors in the audit report. BellSouth urges the Commission to consider revising its audit process to permit carriers subject to an audit an opportunity to comment on the audit findings prior to a Commission decision on whether or not an enforcement proceeding is warranted.

Respectfully submitted,

BELLSOUTH TELECOMMUNICATIONS, INC.
By its Attorney:

M. Robert Sutherland

M. Robert Sutherland
4300 Southern Bell Center
675 W. Peachtree Street, NE
Atlanta, GA 30375

Phone: (404) 529-3854

November 8, 1993

Deloitte & Touche

Management Consulting

Suite 2000
285 Peachtree Center Avenue
Atlanta, Georgia 30303-1234
Telephone (404) 220-1500

November 8, 1993

BellSouth Corporation
Suite 800
1133 21st Street, N.W.
Washington, D.C. 20036

Attention of Mr. Maurice P. Talbot, Jr., Director, Federal Regulatory

Dear Sirs:

The purpose of this letter is to present our findings and conclusions with respect to the analyses and procedures we performed regarding the audit of the affiliate transactions between BellSouth Corporation's (BSC) regulated and non regulated subsidiaries for the calendar years 1984 through 1990 by the Audits Branch of the Common Carrier Bureau of the Federal Communications Commission (FCC). The BellSouth Affiliate Transaction Audit Summary of Audit Findings referred to in FCC Order 93-487, states that BSC's unregulated affiliate, BellSouth Services Incorporated (BSS), had earnings above the authorized rate of return aggregating $25,666,000 for the seven years from 1984 through 1990.

At your request, we have performed a computation of the earnings of BSS for the period 1984 through 1990. The results of our computation are as follows:

Year	FCC Authorized Rate Of Return	BSS Earnings Above (Below) Authorized (000's)
1984	12.75%	0
1985	12.75%	0
1986	12.75%	$2,512
1987	12.00%	444
1988	12.00%	(5,813)
1989	12.00%	13,253
1990	12.00%	(20,408)
		$(10,012)

The basis for our computation was the same as we understand was employed by the Audits Branch, but utilized the following criteria:

1. Capital leases for 1985 through 1987 in the amount of approximately $104,000,000 were excluded from the calculation of the BSS rate base. We understand that capital leases were not required to be included in rate base investment calculations until 1988 (Docket No. 86-497). Use of this criteria resulted in a reduction in the indicated overearnings for 1986 from the $9,837,000 stated in the Summary of Audit Findings to our calculated $2,512,000.

2. Our computation included the effect of computed BSS underearnings for 1988 of $5,813,000 and 1990 of $11,794,000 and the effect of a voluntary rate reduction to ratepayers made by South Central Bell and Southern Bell Telephone in 1990 which we understand totaled $8,614,000 plus interest.

3. The earnings computation for 1984 and 1985 excludes the effect of any earnings component on costs recovered from South Central Bell and Southern Bell Telephone. The BSS pricing mechanism used by BSS in 1984 and 1985 did not include an earnings component on sales to the regulated affiliates, although earnings did occur in these years due to unanticipated year-end adjustments (e.g. year-end revaluation of inventory due to changes in copper prices or obsolescence) and because sales were made to unregulated affiliates and non affiliates where the pricing did contain an earnings component.

As a consequence of performing our engagement, we became familiar with the management control mechanisms in place at BSS during the period 1984 through 1990 to control the amount of BSS earnings that was charged to South Central Bell and Southern Bell Telephone. The principal mechanism used for this purpose was a "Life-To-Date Methodology" that was designed to produce, on a product line by product line basis, an appropriate level of earnings on a rolling multiple-year basis. We observed that the following criteria were applied by BSS in their exercise of this methodology:

1. Unanticipated year-end adjustments (due to changes in copper prices or obsolescent inventory write-offs, for example) which could not be foreseen and considered in the pricing mechanism in advance of their occurrence, resulted in BSS missing their targeted cost recovery or earnings target.